

ABSTRACT

The purpose of this study is to examine the impact of foreign aid on economic growth, in general, and to test the Burnside and Dollar (2000) hypothesis that aid given to countries with good policy environments is more effective than the aid given to countries with poor policy environments as well as testing for diminishing returns to aid and whether foreign aid exhibits diminishing returns conditional on foreign aid being distributed to good policy areas. The study has used Official Development Assistance (ODA) as a proxy variable for foreign aid.

The study has applied quantitative research methodologies on panel data consisting of 22 Asian Countries and a time period from 1960 to 2007 (containing eight six-year averages). The Instrumental Variables (IV) method (2SLS) with time fixed effects is applied to examine the relationship between foreign aid and economic growth. The Instrumental Variables (IV) procedure is used because it takes into account the potential endogeneity between foreign aid and economic growth. The instruments used in this study are logarithm of population and the logarithm of land area. In line with Burnside and Dollar (2000), a composite policy index is constructed using current account balance, inflation and a dummy variable representing trade openness of the economy.

The study results reveal that there is significant negative relationship between foreign aid and GDP per capita growth. Foreign Aid that is intended to foster economic growth may enable some countries to divert money to other non-productive activities. This increases the burden of public debt along with increased external dependency. The study also finds the insignificant relationship between the interaction term Aid*Policy and GDP per capita growth that implies that aid effectiveness is not conditional on good policies. The study results also reveal that foreign aid does not increase economic growth at a decreasing rate that is aid does not suffer from diminishing returns and aid does not suffer from diminishing returns even in a good policy environment.